

The Economic Future of Cyprus

post-settlement prospects



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Introduction

While there have been numerous studies on the political aspects of a settlement to the longstanding Cyprus problem, far less attention has been paid to the associated economic possibilities. In fact, the economic benefits linked to achieving a political settlement on Cyprus are quite compelling, for both sides. These benefits include:

- Accelerated economic growth, particularly on the Turkish-Cypriot side;
- Increased employment and improved quality of job opportunities; and
- Expanded sectoral activities, especially in tourism, construction and finance.

Further, a settlement would create a favorable environment in which to make needed structural adjustments as both sides look toward the future. Structural transformation can be painful, but is always less so if economy-wide output levels are maintained or even increased, as would almost certainly be the case in Cyprus after a settlement.

Overall, the economic prospects that a peaceful, post-settlement Cyprus could offer its Greek-Cypriot and Turkish-Cypriot citizens need to be understood in context. The first section of this paper will describe these prospects in detail; the second will delve into specific sectors, focusing on growth trends and potential. In the third section, the paper will explore the different characteristics of Cyprus' post-settlement economy, each of which will contribute to its long-term development and growth.



Background and Methodology

This paper is the product of a series of discussions on the future economy of Cyprus. These discussions have included both Cypriot and international experts in a wide variety of fields and with vast experience in economic policy, government, financial markets, the private sector, and the region. While it is based on solid economic research, the paper reconciles the cold, hard numbers with the unique political character of the island and the forces that will affect its future.

Most of the economic research on which the paper is based was conducted by Nathan Associates Inc. Nathan was asked to undertake a program of economic research and analysis on Cyprus' economy in August 1999. Operating under a grant from the U.S. Agency for International Development (USAID), the 1999 effort was designed to analyze the possible economic consequences for Cyprus of a political settlement between Greek Cypriots and Turkish Cypriots. Research into economic data and indicators was reinforced and extended by a wide-ranging set of interviews with many individuals on both sides of the island. Loose economic "scenarios" were developed in the framework of simple spreadsheet models, formulated to take account of expected changes in several economic variables over time. The result of this effort was a set of rough projections of the economic future of each side's economy, assuming that some sort of a political settlement was achieved.

To refine this analysis, Nathan—again under a grant from USAID—organized an Economic Focus Group Session in Nicosia in June 2000. Twenty Greek-Cypriot and Turkish-Cypriot academic, business, and policy experts met with an array of international "Cyprus-watchers" and experts on related issues (e.g., European Union accession and the economic dimensions of political dispute resolution). The group thoroughly reviewed research findings and assumptions, examined "unknowns and unquantifiables" in the research, and generally provided a "reality check" on the analysis.

That analysis was complemented by constructive comments from a select group of experts and was refined into this paper, which attempts to outline the economic benefits associated with a political settlement on Cyprus. The assumptions on which this paper is based—and they are indeed only assumptions—reflect widely held views among the experts consulted in this process, but in no way express the official views of Nathan Associates, the U.S. Embassy, USAID, or any other U.S. government agency. While the ultimate terms of a Cyprus settlement and the economic effects on the island are impossible to predict with certainty, this analysis is based on carefully considered and well-supported estimates in the political, economic, and social spheres.



Post-Settlement Economy: Prospects for Growth

A political settlement to Cyprus' longstanding conflict, almost regardless of its precise terms, will have significant economic benefits. A settlement will generate higher levels of macroeconomic growth; increases in the quantity and quality of employment opportunities, accompanied by a decrease in under- and unemployment; and important sectoral shifts in the structure of Cyprus' economy.

The overall growth prospects associated with a settlement would have two additional important benefits. Not only would the growth generated by a settlement help to accomplish structural adjustment needed in the Turkish-Cypriot and Greek-Cypriot economies, but under the most favorable growth scenarios, a settlement would also lead to a progressive convergence of living standards on the two sides.

Macroeconomic Growth

While a number of variables make estimating post-settlement economic growth rates a risky proposition, there is a wide consensus that a settlement will have a positive impact on both the Greek-Cypriot and Turkish-Cypriot sides. Estimates range from the conservative to the dramatic, but all point to higher overall rates of growth in total output of goods and services (i.e., real Gross Domestic Product, or GDP). For the Turkish Cypriots, the rate of increase in real GDP (i.e., after adjustment for inflation) over a twenty-year projection period will be particularly significant: with a settlement, average growth rates could range from 60 to 150 percent higher than those without a settlement. Attaining these levels will require aggressive and consistent economic performance in such key sectors as tourism, construction, commercial and personal services, finance, and manufacturing. Such growth patterns would similarly require increases in demand for goods and services on the Turkish-Cypriot side, plus dramatic increases in levels of investment and labor productivity. Attaining these increases in demand, investment, and productivity would depend, in part, upon how well the Turkish-Cypriot and Greek-Cypriot economies interact and cooperate as well as on the magnitude and timeliness of the financial resources that the international public and private sectors make available to post-settlement Cyprus.

The impact of a settlement on macroeconomic growth on the Greek-Cypriot side would be more modest, but the growth rate with a settlement would still be between 5 and 20 percent higher than without. This would be reinforced by the important—though difficult to measure—psychological benefits that would accompany resolution of the Cyprus conflict and would almost certainly improve the overall investment climate on the island.

Employment Growth—Quantity and Quality

A settlement would also have positive effects for employment demand on Cyprus. The growth in employment on the Greek-Cypriot side could be roughly 25 percent higher with a settlement than without. On the Turkish-Cypriot side, a settlement could lead to sharply positive growth in employment. Without a settlement, employment growth stands to stagnate or even decline. In real terms, the estimated average annual increase in employment growth could range from 1.6 percent to 3 percent, depending upon the size of the economy's overall rates of increase in output. Perhaps equally important, in both economies the quality of employment would improve, as economic growth and productivity gains brought about by expanded investment would imply increased demand for skilled labor. For the Turkish Cypriots, a settlement would mean a significant progressive decline in the overall rates of unemployment and, more importantly, underemployment. In particular, with a set-

tlement, the distortions and pressure created by the present economic isolation of the Turkish-Cypriot private sector would disappear. Thus relieved, private business probably would be able to absorb more labor and reduce hidden unemployment, especially in agriculture and the public sector. In the Greek-Cypriot community, where unemployment is already quite low, there is the risk of labor shortages that would result in a need to continue to import skilled workers. On both sides, however, a booming economy (based on the economic stability and confidence engendered by a settlement) can be expected to attract Cypriots living abroad and to motivate those living on Cyprus to stay, effectively countering the so-called "brain drain" effect.

Key Sectors

With a settlement, the sectoral structure of Cyprus' economy would change. On the Turkish-Cypriot side in particular, levels of output would be higher in nearly every sector. The shares of tourism, construction, and finance within the total economy would increase significantly. A settlement could also help expand or create certain non-traditional activities, namely tertiary education as a regional service industry and possibly information technology services. Agriculture and manufacturing would, however, decline in importance. A settlement would also lead to higher output levels in most sectors and sub-sectors on the Greek-Cypriot side, but the growth in construction, tourism, utilities, and transportation would be particularly pronounced. Public administration's share of the total Greek-Cypriot GDP would decrease, in part because of a "peace dividend" reduction in military spending.

On both sides, private business would likely be the engine of growth for Cyprus' post-settlement economy, spurred by its presumed accession to the European Union (EU). In Cyprus' economic future, the public sector would likely be rationalized, and there would be increased incentive to privatize functions formerly handled by government but best performed by private enterprise.

Structural Adjustment

The economic growth that likely would accompany a settlement has important implications for the structural adjustment that is an inevitable element in Cyprus' economic future. Structural adjustment must take place on both sides as Cyprus harmonizes with the European Union and as the Turkish-Cypriot economy modernizes. In any economy, structural transformation requires shifting employment and investment out of relatively less productive sectors into more efficient ones, allowing the economy undergoing these adjustments to become more competitive overall and to grow more rapidly. Such adjustments can be painful, but are always less so if they can be undertaken in a framework where total levels of production are not falling. When output levels economy-wide can be maintained or even increased, employment in lagging sectors can be reduced by attrition, with shifting workers absorbed by growing sectors. When output is declining economy-wide, workers in large and lagging sectors are typically forced out and may remain idle due to fewer opportunities to be absorbed elsewhere.

For Cyprus, therefore, a settlement would create a favorable framework in which to make needed structural adjustments. First, a settlement means higher GDP for most sectors on both sides—more output and opportunities to be shared by all, even those working in declining industries and activities. Second, because a settlement would allow sectors to decline in relative terms without undergoing sharp contractions in an absolute sense, it would cushion difficult structural adjustments. This structural adjustment benefit would be especially important for the Turkish Cypriots, where the dislocations associated with sectoral transformations in finance, agriculture, and the public sector are likely to be substantial.



Sectoral Activities, Opportunities, and Challenges

Cyprus' overall post-settlement economic prospects are in large part a function of the specific activities, opportunities, and challenges that a settlement would mean for individual sectors. In Cyprus' post-settlement economic future, the leading sectors to create growth and development would be tourism, construction, and finance. The potential for significant economic contributions by non-traditional sectors, including tertiary education, is also large.

Tourism

With a settlement, Cyprus will become a more attractive tourist destination and thus should experience strong growth rates in the tourism sector. Areas in the north rich in historical assets and natural beauty would become more accessible; tourism support services (tour guides, rental cars, etc.) would be able to operate island-wide; and the whole of Cyprus could be more effectively marketed, either as a single, diverse destination or as part of a package with regional leaders like Greece and Turkey. A joint tourism marketing program and budget would help promote Cyprus in a fiercely competitive Mediterranean tourism market and help boost the Cypriot tourism industry generally. Cyprus' geographical location could also make it a convenient and logical air travel hub, linking Europe, Africa, the Middle East, and Asia.

While tourism is a business vulnerable to external shocks, Cyprus' experience shows that these risks can be managed. Moreover, tourism is clearly at the center of Cyprus' comparative advantage. With a settlement, all of Cyprus likely would experience continuing sharp growth in visitor numbers, which could be complemented by a strategy to increase the quality of visitors to the island. The expatriate Cypriot community can be expected to be an additional source of visitors who will take advantage of peaceful conditions (and curiosity) to return and tour the island. Tourism businesses island-wide would try individually and collaboratively to improve the tourism product of Cyprus, by going up-market to capture a higher-spending, less-seasonal clientele. Such efforts would help maximize the net economic benefits of tourism while minimizing the damage wrought to the natural environment, which ultimately debases the quality of the tourism product. Conference tourism, eco-tourism, and visitor industry based on hunting and yachting are all possibilities.

With such dramatic expansion in tourism activity, careful monitoring and management of environmental impacts would be necessary. Such sensitivity to environmental considerations would be needed not only to preserve Cyprus' natural beauty and make more efficient use of scarce natural resources (water), but also because environmental protection has become a marketing asset in the presentation of Cyprus to some tour operators in Europe.

Construction and Infrastructure

A settlement can be expected to provide an especially strong boost to the construction sector island-wide. Construction activities are highly labor intensive and would create jobs and wages with economic multiplier effects. This boost would come from three different sources. First, and perhaps most important in the near term, very soon after a settlement it can be assumed that major high-impact urban renewal projects for Varosha and Nicosia will be undertaken, each with very significant investment and employment effects. For example, the reconstruction of Varosha calls for the creation of an entire neighborhood. This program alone would involve an infusion of investment funds on the order of several hundred million US dollars, and would call for massive amounts of labor, much of it from within the Turkish-Cypriot community. Further, significant effective demand



for refurbishment and reconstruction could also be unleashed by the property arrangements within a political settlement. This activity would provide important and immediate stimulus to the construction sector.

Second, with a settlement it would be possible to implement a whole variety of large-scale infrastructure development projects for Cyprus. These will include building and improving major highways to connect roads across the island, as well as upgrading and expanding island-wide power and telecommunications systems. Major port and airport developments would also be undertaken to facilitate international transportation linkages and benefit consumers and producers island-wide. Finally, construction would also benefit from the development of several water projects for the whole of Cyprus.

Third, to the extent that a settlement provides a strong boost to tourism, demand will increase for improved and expanded facilities. On both sides, there has been some overbuilding of tourism facilities, so there may be some lag in the growth of tourism-related construction. It can, however, be assumed that once present facilities reach capacity and domestic capital begins to move relatively freely in joint venture tourism projects between Greek Cypriots and Turkish Cypriots, construction in the tourism sector will grow rapidly. The challenge will be to maximize growth in this sector while avoiding haphazard construction and environmental damage, especially in the all-important coastal areas of the island.

Financial Sector

Cyprus has already demonstrated its vocation as an important regional financial center, and would likely continue this role in the post-settlement future. The forces that influence this sector most—EU harmonization and globalization—have already begun to shape the Greek-Cypriot financial institutions. Many of the reforms needed in Greek-Cypriot banking and finance have already been accomplished or are programmed for the near future.¹ With a settlement and EU accession, the entire island will see positive results as investors, both direct and portfolio, take a more positive view of the risks of investment in Cyprus.

On the Turkish-Cypriot side, a settlement would have another profound effect. It would create pressure for a restructuring of the Turkish-Cypriot banking sector, which is presently in serious disarray. This restructuring would likely feature adoption of a single, stable Cyprus-wide currency; acceptance of a central bank regulatory and supervisory function consistent with EU standards; abolition of interest rate ceilings and capital controls; an end to directed credit and credit controls; restriction or phase-out of offshore-banking units; and transformation of linkages with the Turkish banking sector to a commercial basis. As a result, after a period of intense restructuring, the economic importance of the financial sector on the Turkish-Cypriot side could be expected to steadily increase.

Other Sectors

Public administration, manufacturing, and agriculture would in general be declining sectors in the post-settlement economic future of Cyprus.

1. Reforms already in place or soon to be implemented in the Greek-Cypriot financial sector include, for example, removal of exchange and capital controls; removal of ceilings on interest rates and interest charges; harmonization of bank regulation and supervision with European norms; creation of deposit insurance schemes; strengthening controls to prevent money laundering; and tightening rules on offshore banking.



- **Public administration:** This sector can be assumed to have considerable built-in stability in both economies as a result of an expenditure base that centers largely on personnel and the presence of strong labor unions. However, with a settlement, two impacts can still be assumed. First, on the Greek-Cypriot side, there would be a significant decrease in defense-related expenditures. Second, on both sides, it is assumed that public-sector employment would decrease because of attrition and improvement in labor productivity as the public administration is rationalized. While to some extent both trends would be offset by the employment and expenditure impacts of newly created central government functions for post-settlement Cyprus, over all, the public administration share of total GDP would likely decline on both sides.
- **Manufacturing:** With a settlement, it is assumed that benefits for both sides would be slight, and largely a function of new possibilities for cooperation in joint ventures in agro-processing and textiles. In general, Cyprus has little comparative advantage in manufacturing. Nevertheless, some industries or enterprises (e.g., dairy and cheese) would be able to successfully exploit niche markets. In addition, with a settlement, some new opportunities could emerge for “Made in Cyprus” goods and services to be exported into the relatively untapped Turkish market, thus boosting prospects for some manufacturing enterprises and creating more jobs.
- **Agriculture:** Throughout Cyprus, agriculture is in decline. As a general matter, agricultural output is no longer competitive with foreign agricultural products and to survive Cypriot agriculture has required extensive and expensive supports on both sides. These supports include water subsidies, low-interest loans, price subsidies, and import restrictions. Some of these subsidies are presently being reduced and are likely to eventually disappear, despite strong political resistance due to vested interests and possible social dislocation. In any event, the rational use of resources that would be encouraged by a settlement would accelerate the island-wide downward trend in agriculture. While there may be some targeted opportunities in high-end, niche cultivation (spices, herbs, honey), over all, a declining agricultural sector will free up labor and capital for more productive uses elsewhere in the economy.

Non-traditional Sectors, Including Tertiary Education

Non-traditional activities could play an important role in Cyprus’ economic future. Given the evolving global economy, information technology, research, and educational services could in fact become significant economic drivers in Cyprus’ post-settlement future. Tertiary education holds interesting potential as well. The present performance of the private, higher-education sector in the Turkish-Cypriot economy provides an indication of the economic significance that tertiary education might take on subsequent to a political settlement. Currently, Turkish-Cypriot tertiary educational institutions serve a total of 20,000 students per year, most from overseas, and generate export earnings of about US\$150 million. In the post-settlement world, universities island-wide might be able to expand and become a collaborative, EU-based center of higher education for the Mediterranean and Middle Eastern region.

A settlement could also give Cyprus an opportunity to develop as a high-tech and professional-services center. Peaceful conditions, together with Cyprus’ well-educated work force, favorable location between Europe and the Near East, and successful experience to date in the service industry should make it possible for the economy to expand in knowledge-based, export-oriented service areas. These could include software development and other information technology services, as well as health care, legal services, and business support services such as accounting and consulting. Strong and vibrant universities would be key to developing these types of economic activities. However, to be successful in high tech, Cyprus would have to demonstrate its competitive advantage and increase its investment in and incentives for research and development, innovation, and science and technology.



Characteristics of Cyprus' Post-Settlement Economy

The macroeconomic and sectoral growth prospects outlined above depend upon a broad range of assumptions regarding the institutional framework and other factors that would support, and promote, economic performance in the post-settlement future.

Economic Structures and Institutions

Many possible political relationships exist that could change the current status quo of non-recognition/almost-no-interaction between the Greek-Cypriot and Turkish-Cypriot sides. Given its non-political focus, this outline of post-settlement economic prospects simply assumes exclusion of two options: Cyprus' division into two independent states, and Cyprus as a single unitary state. After the exclusions, this assumption implies the existence and operation of a single bizonal entity, recognized by the whole international community, and consisting of two component states administered by the Greek-Cypriot and Turkish-Cypriot sides, respectively.

While the details of how the central government would be constructed is part of the negotiation process, in economic terms, it is assumed that the political settlement ultimately envisages the possibility of effective economic relationships between the two sides, so that both may benefit from maximum efficiency in the use of resources. In the private sector, these economic relationships may feature joint ventures and other forms of business ownership and collaboration. In the public sector, economic relationships could operate through a diverse set of government economic institutions. At the center, these would probably include a single central bank to regulate the financial sector; a common currency; and possibly, a single authority to oversee air transport and another to do the same for sea transport, including a common shipping registry. A settlement might also include—or grow to include—a set of central taxing, borrowing, and spending agencies concerned with island-wide economic progress and living standards. These types of central institutions would be complemented by economic organizations working at two other sub-central levels—the component state level and the community level—where economic activity within and between the two sides could be planned, developed, and managed. Within this assumed framework, many different forms of a settlement might be devised. Ultimately, the growth prospects set forth herein could apply to all with equal validity, but would of course be influenced by the degree to which economic, rather than political, considerations are allowed to determine economic interaction.

European Union Dimension

In the present outline of post-settlement economic prospects, a political settlement is assumed to precede Cyprus' entry into the EU and facilitate the accession process of a post-settlement Cyprus. In general terms, EU membership offers very significant long-term economic benefits to Cyprus through the opportunities it would provide to participate in the integrated European market (with its 370 million consumers) for goods, services, and investment flows. But in the context of the economic prospects of post-settlement Cyprus, EU membership has at least three other major and specific implications.



First, EU membership for Cyprus would require adoption of the *acquis communautaire*. This has many positive implications: the pre-existing package of institutions, laws, and regulations associated with EU accession would provide detailed guidelines to organize basic, market-oriented economic relationships for post-settlement Cyprus. As a result, by shaping the post-settlement economy to be consistent with the *acquis communautaire*, economic policymakers and managers on both sides would smooth the way for EU accession and at the same time save considerable time, energy, and debate in designing post-settlement economic institutions.

Second, EU membership would also mean reform of day-to-day economic practices and policies throughout Cyprus to conform to the principles of the *acquis communautaire*.² For the Greek-Cypriot economy, this effort is already underway. Many of the economic preconditions for EU accession have already been met and all remaining reforms are likely to have been accomplished before 2003, that economy's target for fulfilling all EU membership requirements.³ For the Turkish-Cypriot side, the task of liberalizing and reforming economic institutions and activities has not yet begun. Restructuring and adjustment in anticipation of EU accession would therefore be a major theme of economic policy-making across all sectors of the economy in the north in the period immediately following a settlement.⁴ For both sides, though, adopting the EU's set of economic practices and policies will improve perceptions and realities, especially from the investor's point of view.

Finally, EU membership would mean access to very significant capital resources, especially for the Turkish Cypriots. First, the EU would make available resources focused on pre-accession assistance. For example, assuming a settlement were in place, funding would become available to offset the expenditure involved in adopting the *acquis communautaire*, as the Turkish-Cypriot component state's economy strives to conform to EU standards. Further, the Turkish-Cypriot side would also receive pre-accession grants and loans aimed at helping integrate its economy into the EU, plus some risk-capital financing from the European Investment Bank designed to assist enterprises in preparing for competition in EU markets as a result of accession.⁵ Additionally, and even more substantially, with EU accession, the Turkish-Cypriot community would also benefit from financial aid, particularly in the form of the capital grants from the EU's Regional Development Fund. This facility is targeted at the rel-

2. One of the main changes accompanying EU accession is likely to be the elimination or severe restriction of offshore banking and other offshore businesses. Without special arrangements, EU tax harmonization requires that tax systems be similar in every member country. Offshore banking in Cyprus (or anywhere else) exists in large measure to take advantage of favorable tax treatment. Once special treatment is removed, offshore activities tend to go where such treatment would still be available. No EU "special arrangement" is assumed for Cyprus' offshore banks or other offshore companies.

3. In the Greek-Cypriot economy, full liberalization of several key economic sectors—notably financial, air transport, and telecommunications—constitutes one major set of transformations still to be accomplished by the target date. Additionally, for EU membership, the Greek-Cypriot economy would need to drop subsidies to agriculture and manufacturing, and end special tax treatment for income from exports.

4. To cite two sectoral examples, with EU accession Turkish-Cypriot agriculture would need to adjust to the loss of preferential markets in Turkey for some agricultural products, as EU rules prohibit such bilateral arrangements. However, EU accession would have little impact on Turkish-Cypriot exports of non-agricultural products to Turkey, since the latter already has a customs union with the EU and extends no important preferences to Turkish Cypriots for non-agricultural goods. Hence, conditions faced by Turkish-Cypriot producers of non-agricultural goods are and would be about the same in both the EU and Turkish markets. Over the long term, Turkish-Cypriot agricultural and non-agricultural community products may find new opportunities in the EU, but to do so would need to become significantly more competitive in price and quality.

5. Between 1995 and 1999 (the EU Fourth Protocol) EU pre-accession assistance to Cyprus totaled about US\$71 million, and about another US\$250 million may have been provided to Cyprus in the form of European Investment Bank loans during that time. The Greek-Cypriot economy has benefited from these funds. However, some of these pre-accession and EIB financial resources were intended to serve the Turkish-Cypriot economy, and have gone unspent largely as a result of the Turkish-Cypriot community's decision to forego participation in EU programs after the EU's 1997 postponement of an acceptance of Turkey's EU application.

atively poorer regions within EU member countries, and aims to raise living standards in such regions to 75 percent of the EU average. Based on its current level of GDP per capita, the Turkish Cypriots would qualify for this support. By way of reference, EU regional development funds flowing to Greece and Portugal under this facility are reported to have totaled an estimated US\$16.5 billion for each country between 1994 and 1999. At an equivalent per capita funding level, the Turkish Cypriots could therefore reasonably expect about US\$65 million annually in EU regional development financing alone. Moreover, the EU has several other sources of assistance for which Cyprus, or the Turkish-Cypriot side, would qualify: funds for agricultural support, rural development and reforestation, and for promotion of "cohesion" among EU member states, especially through development of transport systems and environment management.⁶ While impossible to estimate, it is also likely that the EU as well as other parts of the international community will be eager to find additional means to support—financially and otherwise—a settlement on Cyprus.

Currency and Inflation

After a settlement, a common currency pegged to the Euro, or the Euro itself, will likely be used all over the island. For the island as a whole, this will (1) imply greater macroeconomic stability, especially to businesses and potential investors; (2) promote good economic management; and (3) reduce price volatility arising from exchange-rate fluctuations. In effect, the adoption of a currency closely pegged to the Euro, or the Euro itself, will mean that Cyprus will not have an independent monetary policy and inflation would be the European average. At the same time, there would be no exchange rate problem vis-à-vis Europe.

Because the Cyprus Pound is already rigidly tied to the Euro, the new common currency would not be a big change for the Greek Cypriots. For the Turkish Cypriots, however, adoption of a currency pegged to the Euro would stabilize prices and exchange rates by ending the inflation that is imported from Turkey through the Turkish Lira. Such stability would in turn have a very positive impact on the overall economy by stimulating trade and investment, both foreign and local.

Movement of Economic Factors

In a politically neutral environment, market forces and rational economic behavior would move the two sides toward extensive cooperation. Consistent with the requirements for economic efficiency and eventual European Union membership, it is assumed that a settlement would in principle be based on some flows of people, capital, goods, and services between Greek Cypriots and Turkish Cypriots. In fact, however, for some economic factors, "transitional arrangements" are likely to regulate mobility.

It is important to recognize that ending limitations on mobility will improve economic efficiency, which depends upon capital and labor being freely applied where they would be most productive and earn the highest economic returns. The more widespread the "transitional arrangements" or other limitations to the movement of economic factors in a post-settlement Cyprus, the greater the loss of potential economic growth and the lower the prospective level of economic growth performance. Ultimately, however, in the liberalized, modernizing, EU-oriented future economy of Cyprus, origin of labor or ownership of

6. Note that after taking account of the potential flows from all EU agriculture, structural, and cohesion funds, the Republic of Cyprus' chief EU negotiator estimates that after accession the island's economy could benefit from as much as EURO 200 million per annum in assistance.

capital—by nationality or ethnicity—would become far less significant in determining employment or capital flows than the prospective productivity of workers to be hired or the prospective rates of return of investment opportunities to be financed.

Property Rights, Claims, and Compensation

The contentious issue of property claims will be addressed as part of the settlement. The nature of the institutions or mechanisms for settling these claims or the value of compensation to be paid is not taken up in the present analysis. However, it is assumed that an agreement on property claims and territorial adjustments would be implemented early in the post-settlement period. This would facilitate the large-scale reconstruction investments that are an important initial growth and employment generator for the economy on both sides. The international community is assumed to provide financial resources to help meet compensation requirements. Also, with a political settlement there would be a provision to guarantee property rights. This alone will improve the investment climate and entice foreign and/or domestic investment to refurbish or reconstruct formerly disputed properties.

Financial Aid to the Turkish-Cypriot Side of the Economy

On an annual equivalent basis, Turkey reportedly provides at least US\$100-200 million in economic aid and financial support to the Turkish Cypriots. This assistance takes the form of direct aid, loans, subsidies, and other grants. With a settlement, this figure is likely to be reduced. This would facilitate Turkey's adherence to a tough IMF program that pressures Turkish policy-makers to decrease public expenditures and reduce that nation's fiscal deficit. With an end to the conflict in Cyprus, Turkey would no longer need to serve as the single economic lifeline. Ankara could expect the international community to provide funds to promote development of a balanced Cypriot economy, with particular benefits for Turkish Cypriots.

With a settlement, it is also expected that funding from both domestic and international sources would flow into the Turkish-Cypriot component state's economy. The most important of these sources would be the European Union. As noted earlier, some EU assistance would be made available in the form of accession support, but more important would be the flow of EU Regional Development Fund capital grants for the Turkish-Cypriot side, perhaps on the order of US\$65 million per year. Assuming that EU policies remain unchanged, these grants would begin with the accession of Cyprus to the EU and would continue until Turkish-Cypriot per capita GDP rose to a level of 75 percent of the overall EU average. Additionally, considerable international aid would also flow to Cyprus with a political settlement. Finally, foreign private institutions and individual investors could also provide development financing by purchasing debt instruments (e.g., "Peace Bonds") to be issued by Cyprus' new central government authority.⁷

Domestic Cypriot finance can be another critical source of funding to support development of the Turkish-Cypriot component state's economy in the post-settlement era. This funding could take the form of capital transfers funneled from taxpayers to

7. Such Cyprus "Peace Bonds" could also be made available to domestic Cypriot institutional and individual investors as another means of raising reconstruction and development finance.

the Turkish-Cypriot economy by the post-settlement central government's economic agencies. Many of these transfers could fund major infrastructure projects to benefit the island-wide economy, as well as social security benefits, health services, and education. It is imperative that the transfers be managed carefully and spent in effective and transparent ways.

"Peace Dividends"

With a settlement, it is assumed that Cyprus would benefit from two important and tangible "peace dividend" impacts. First, it is assumed that a settlement would include some structure of international guarantees for the future safety and security of Cyprus. This structure would permit a phased demilitarization of Cyprus. Turkish, Greek, Turkish-Cypriot, and Greek-Cypriot military expenditures would all decline. The Turkish-Cypriot economy would lose some of the consumer expenditures made in the past by Turkish military personnel, although such income losses might be offset by increased procurements by UN peace-keeping forces. Decreases in Greek-Cypriot military spending would free financial resources for investment and current expenditure in public services.

Second, with the cessation of a state of tension, the risk rating of Cyprus would change, which would have a significant and positive impact on the flow of capital to both sides of the island. In the post-settlement period, the island-wide investment climate would improve dramatically, both in the perception of the international business community, and in fact, as peaceful conditions permit consideration of an array of possible new project opportunities. A settlement would lead to a heightened interest in Cyprus among foreign and domestic business people, and a substantial rise in private-sector investment. Cyprus' accession to the EU would further reinforce this investment effect.

Finally, with a settlement, another more intangible but very real "peace dividend" would also be realized. This benefit would flow from removing the hidden economic costs of the present political conflict: distortions, duplications, and inefficiencies in economic behavior to offset political uncertainties, economic possibilities lost, and human resources fleeing Cyprus to avoid the limitations of the current environment. These costs are not quantifiable, but their elimination would represent a very real net economic benefit to both communities.

Fiscal Structure

As noted earlier, a settlement is assumed to create a diverse set of economic institutions, some centralized and others at the component-state and community level. These institutions would provide a three-tiered fiscal structure to fund public sector capital and current expenditures in each community as well as any island-wide, joint public administration activities. Under this structure, it is assumed that a central government would have some taxing and borrowing authority to raise funds to finance large-scale infrastructure and other development programs of benefit across the island. It is also assumed that each component state would have taxing authority to raise revenue from its own residents for its public expenditures. Each component-state public sector might also have limited powers to borrow. And finally, local community or municipal government units could have limited spending authority based on local taxation.

A three-tiered fiscal structure would also be useful in supporting internal resource transfers in a post-settlement Cyprus. Under this structure, central-government institutions could raise taxes island-wide to support economic development in Cyprus gen-



erally, and then use the funds to (1) make direct capital and current expenditures affecting the two sides, and (2) provide direct grants to Greek-Cypriot and Turkish-Cypriot authorities, who in turn could deliver services or sub-grants to communities and municipalities in their respective areas. It is assumed that the bulk of the central-government grants would be directed to the Turkish-Cypriot side to accelerate its growth and development and raise its average standard of living. This structure could safeguard the autonomy of the two component states while providing for a central EU-compatible entity to raise the economic standards and status of the island overall.

Regional Economic Ties

Given Cyprus' comparative advantages of location and record of accomplishments as a service-oriented economy, it is assumed that in the post-settlement world, Cyprus would play a steadily growing role in the regional economic activity of the eastern Mediterranean. For example, in addition to its established vocation as a regional financial center, Cyprus' location and skill base might enable it to develop as a regional air transportation hub and/or a maritime service center. Further, Cyprus could use its EU membership to become a commercial outpost of the European Union in the Middle East and eastern Mediterranean. In so doing it would marry its access to the EU and adherence to EU economic standards and policies with its connections to and knowledge of Middle Eastern markets and business to promote and participate in two-way trade and financial flows.

With a settlement, it is also assumed that Cyprus would establish strong and special linkages to Turkey and Greece. In view of Turkey's economic dynamism and dominance in the eastern Mediterranean, as well as its historical influence on Cyprus, Turkey likely would have a large role in the post-settlement economy of Cyprus. This is especially true in view of the EU's December 1999 acceptance of Turkey's application for EU accession. With a large population and business base, and with a liberalizing, rapidly growing economy, Turkey would be a natural long-term partner for Cyprus in regional economic affairs. Both Turkey and Greece could be sources of private investment capital (possibly through joint ventures) for economic activity. Also, in the post-settlement world, Turkey and Greece could provide both skilled and unskilled labor to Cyprus.



Conclusion

A settlement of Cyprus' long-standing political conflict will have important economic benefits for all Cypriots. Most notably, it would accelerate economic growth and increase the employment base, with an expansion of high-quality jobs. This growth would be led by private sector firms and would be concentrated in proven sectors—tourism, construction and infrastructure, and finance. It could also include an increase in non-traditional service activities such as information technology, business-related services, and tertiary education. New project opportunities that a settlement would make possible, including joint ventures and large infrastructure investments deferred over decades of political stalemate, would be among the drivers of this growth.

The economic benefits of a settlement would be most pronounced for the Turkish-Cypriot side. A settlement would raise the prospect of sharp and long-term increases in rates of growth in real GDP to levels of 5.5 percent per annum or even higher. This growth path would not only ease the problem of making needed structural adjustments in the Turkish-Cypriot economy, but would also result in a significant rise in living standards. While the growth impacts of a settlement for the Greek-Cypriot economy would be more modest—a settlement would help that economy to sustain long-term growth rates in real GDP of 4 percent to 4.5 percent per annum or even higher—they would be reinforced with important (albeit non-quantifiable) quality-of-life economic benefits.

The substance of the outcomes suggested above is affected by the assumptions adopted regarding economic institutions and relationships in post-settlement Cyprus. Without pre-judging the components of a settlement, several of the principal characteristics of Cyprus' post-settlement economic environment seem clear. First, the accession of Cyprus to the European Union would have a profound benefit for both communities by increasing economic possibilities and by providing an institutional/legal framework and a norm against which to re-order economic policies and practices—albeit with some potentially significant transitional arrangements. EU accession would mean the availability of substantial capital flows that would support development, especially on the Turkish-Cypriot side. Second, a settlement would release a “peace dividend” island-wide. This would feature a reduction of defense expenditure to free up resources for non-military uses. It could also mean a steep increase in international private investment flows as opportunities emerge in the new peaceful, Euro-Atlantic-oriented business climate of post-settlement Cyprus. Third, a settlement could develop a multi-tiered fiscal structure in which a common/joint authority taxes and borrows to provide resources to fund island-wide economic projects, plus grants for economic operations of component-state and community-based public agencies, particularly on the Turkish-Cypriot side. Finally, with a political settlement, Cyprus could be expected to expand its position as a key economic actor in the eastern Mediterranean region, including building special economic relations with Turkey.

Of course, one of the most important factors that will shape post-settlement Cyprus economically concerns the extent and duration of “transitional arrangements” and other limitations that would restrict the free flow of labor, capital, goods, and services. Only the parties to the negotiations (and the EU) can determine the extent to which such “transitional arrangements” will be part of a settlement. However, because “transitional arrangements” and other limitations on free movement of economic factors reduce economic efficiency, they would influence economic growth prospects. Extensive and long lasting “transitional arrangements” or other limitations would constrain the island's ability (1) to maximize overall economic growth and potential and (2) to distribute the full economic benefits of a settlement to its residents.



Appendix

Possible Areas for Near-Term Business/Economic Collaboration Between Greek Cypriots and Turkish Cypriots

1. Attitude survey on acceptability of capital transfers in a political settlement using researchers and consultants from both communities to design the questionnaire and analyze the data.
2. Attitude survey on the relationship between European Union accession and a political settlement and the relative priority to be accorded to each side using researchers and consultants from both communities to design the questionnaire and analyze the data.
3. Scenario-planning workshops involving representatives of both communities in which plans would be prepared for joint economic initiatives of mutual concern (e.g., tourism marketing plan, infrastructure development plan).
4. Preparation and implementation of a project to improve animal health and husbandry across the island towards common standards, which might allow for exchange in animals and/or animal products.
5. Preparation and implementation of a project to launch a municipal market in the Nicosia area (economic analysis of the net benefits to be generated).
6. Preparation of a reconstruction plan for a rebirth of the Famagusta area (economic analysis of the net benefits to be generated) using researchers and consultants from both communities.
7. Preparation of a draft master plan for integrated infrastructure development for all of Cyprus (strategy, project opportunities, proposed institutional framework) using researchers and consultants from both communities.
8. Workshop on "opportunities for economic collaboration" in Cyprus involving Greek-Cypriot and Turkish-Cypriot business persons as well as business persons from Greece, Turkey, and other potential trading partners.